



# Employer's Internal FLSA Audit Becomes Evidence in Misclassification Claim

Insights

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Wage and hour litigation remains one of the top types of litigation filed in federal courts. In 2020, in the midst of a pandemic, plaintiffs filed more than 5,000 Fair Labor Standards Act (FLSA) lawsuits. Because many of these cases are brought as collective actions on behalf of large groups of employees, fees can be higher than in single-plaintiff cases. Even a single plaintiff FLSA suit can cost six-figures. There is only limited insurance for these cases and many employers must foot the entire bill for the defense and any resulting verdict.

The litigation spree has motivated employers to scrutinize their payroll practices for FLSA compliance. Areas of concern range from whether employees are properly recording their hours to whether the employer's records are FLSA compliant. One of primary targets of lawsuits, and one of the most important areas to consider when auditing payroll practices, is whether exempt employees are properly classified. A recent decision of the Fifth Circuit Court of Appeals, however, showed how dangerous it can be for FLSA audits to be conducted without attorney assistance.

## Background

One of the foundational principles of the Fair Labor Standards Act is that all employees who work more than 40 hours a week must be paid time-and-one-half their regular rate of pay for those excess hours. There are numerous exceptions. The most commonly litigated are the "white-collar" exceptions, for workers falling in the professional, executive, and administrative categories.

Employees who are paid on a salary-basis and perform certain duties are exempted from the overtime rule. Unfortunately, when it comes to determining if an employee's duties satisfy the exemption, there are few bright line rules and a fact-intensive analysis must be performed. If an employee challenges your conclusion they are exempt from overtime in court, you bear the burden of proof that the exemption was correct.

## The Case

In *Novick v. Shipcom Wireless*, four plaintiffs claimed that the company had improperly classified them as exempt and failed in the obligation to pay for over time. Three of the employees held the position of trainer traveling to customer facilities to train employees in the use of Shipcom's product.

One was an Engineer/Trainer who worked on installation of the product as well as training. Shipcom classified these two positions as exempt under the Administrative exemption.

Shipcom conducted an audit of all its positions for the purpose of ensuring they were properly classified. The audit concluded the trainer position should not have been classified as exempt. Shipcom then calculated how much overtime the Trainers had worked over the prior two years. It paid the two Trainers who remained employed for these hours. It did not offer backpay to the trainer who was no longer employed at the time of the audit. The audit concluded the Engineer/Trainer position was properly classified as exempt and therefore Shipcom made no changes to the pay for that position.

The claims went to a jury. At trial, over the company's objection, the company's audit was a prominent exhibit. The jury concluded all four employees should have been non-exempt and were owed overtime pay. It also awarded liquidated damages finding that the company's decision to classify the employees as exempt was willful. The total amount awarded collectively to the plaintiffs was about \$31,000. The judge awarded plaintiffs' counsel more than \$140,000 in attorneys' fees.

On appeal, Shipcom argued the trial court erred in admitting into evidence its internal audit along with emails discussing the audit process and the need to change the trainers to non-exempt status. The Fifth Circuit disagreed. It first considered whether the audit constituted a subsequent remedial measure – those steps taken after an injury to prevent recurrences, excluded from evidence to encourage fixing problems without concern the repair will be used as evidence of liability. This concept derived from personal injury cases but has sometimes been extended into other areas. The Fifth Circuit concluded the audit was not a subsequent remedial measure and therefore admissible. It likened the audit to a post-accident investigation. The audit only determined what the problems were; it did not fix them. Further, because proper classification is mandated by law, allowing the audit into evidence would not serve to deter voluntary actions.

Shipcom also argued that the audit and related communications were irrelevant. The Fifth Circuit had little trouble dismissing this argument, concluding the audit carried “substantial probative value.”

## **A Different Tack**

Most wage hour audits will find potential issues in an employer's payroll practices. This is not the product of deliberate misconduct or indifference. It derives from the law being complex and often ill-suited to the modern workplace. Exemption issues are particularly problematic because, while some positions fall squarely into a category, there is a large gray area wherein many positions could be considered one or the other depending on the particularized analysis.

Because the FLSA analysis is based on how each individual employee performs the job, two employees holding the same position might have differing levels of responsibility within the position resulting in one being exempt and one not. It is also possible that a jury could tell an employer its

resulting in one being exempt and one not. It is also possible that a jury could tell an employer its careful decision-making process reached the wrong result. The jury in this case not only told Shipcom it had made the wrong call with regard to the Engineer/Trainer it had concluded was exempt, but found in spite of the audit and careful analysis that the decision was willful resulting in the imposition of liquidated damages.

The result in *Shipcom* reveals the importance of conducting wage hour audits in a manner that will not allow the communications and results to be discoverable in litigation or shown to a jury. Even when an employer has every intention of correcting any mistakes found, that will not prevent the affected employees from suing. Shipcom did change what the audit showed was problematic and voluntarily paid the over-time but still was sued by the employees it paid. In that situation, the chances of an employer successfully arguing the jury should ignore its own conclusion is non-existent.

The simplest way to conduct a wage and hour audit in a manner where it will not be discoverable and not get in front of a jury is to have it directed by counsel. When a company's inside or outside counsel audits payroll practices for the purpose of giving legal advice on FLSA compliance, the work done in that process is protected against disclosure by the attorney-client privilege. This confidentiality provides the room an employer needs to consider differing positions without concern that an argument ultimately rejected will be used against it.

Ensuring the entire audit is conducted under the privilege requires certain formalities. Simply having counsel participate in the discussions of the investigation and conclusions made by others may not be enough. The audit should begin with a formalization of the fact it is being done for the purpose of allowing counsel to advise the company. While counsel does not need to perform all the work, counsel should be directing what is done such as what records are reviewed and what interviews conducted. Conclusions should be formal and memorialized.

There are two caveats. First, an employer can use the advice received from counsel as evidence of good faith to defend against a claim for liquidated damages. When doing so, the privilege will be waived and the underlying investigation and the resulting advice will be discoverable and admissible. Second, if changes are made as a result of the audit, the changes themselves may be more probative of wrong doing if there is no context around the decision being a close one.

The key is to have options. Without the involvement of counsel, the work will be discoverable and likely admissible. With the involvement of counsel, the employer can decide whether to maintain or waive the privilege. It is preferable to control that result.

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